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Can Dealmakers Still Dabble In Small-Balance Multifamily?

Issues such as a lack of liquidity and uncertainty about values are less likely to roil the small-balance multifamily universe.

BY JESSICA LILLIAN

Because of its unique attributes, small-balance multifamily lending has reacted to the recent residential and general market turmoil somewhat differently from other sectors. And while the general outlook remains uncertain, market players active in these types of deals should expect some new challenges alongside positive trends.

Commercial mortgage brokers lately have shown increasing interest in small-balance transactions of all types, says KeyBank's Charles Krawitz. Deal difficulties stemming from the credit market's tightening conditions are magnified in larger-balance transactions, he explains, while issues such as a lack of liquidity and uncertainty about values affect small-balance to a much smaller degree.

Charles Krawitz

Additionally, small-balance lending's current - though possibly only partial - insulation from some of the fallout beginning to take place within its larger counterpart may be linked to differences in earlier financing practices, says Krawitz.

In recent years, as less conservative deal structures began to proliferate in some areas of larger-balance commercial real estate, small-balance, which was historically linked to community banking, tended to avoid such risks. With process limitations in place and fewer active securitized lenders in small-balance, "You couldn't get the time and attention necessary to structure something that could get you into trouble," Krawitz points out.

The larger commercial lending sphere, in contrast, appears to have been more strongly in step with such popular loan offerings as low-doc, Alt-A and stated-income deals. "What we've seen over the past couple years - and we've documented this with some surveys suggesting that we've done - is that there is definitely an increasing tilt towards more residential-style underwriting," observes Boxwood Means' Randy Fuchs. The effect of this trend remains to be seen, he says.

However, other recent Boxwood Means data identify a troubling possible link between the performance of the small-balance multifamily market and the residential market: With the smallest of the small-balance loans in particular, a slowdown corresponding to residential's distress showed up in recent numbers.

Randy Fuchs

Many small-balance borrowers are single investors - dependent on their own money - rather than the institutional investors associated with larger-balance lending, Fuchs notes. Krawitz characterizes the typical small-balance participant as a mom-and-pop operator who owns just one or two properties, relies heavily on asset cashflow, and is disinclined to sign an interest-only loan that hinders outright ownership.

Mixed outlook

Regardless of the size of the individual deal, Fuchs states, multifamily in particular may face a growing threat. "I think that there's going to continue to be some turmoil in the commercial multifamily market because of the severity of the problems that are in residential," he says, citing recent data suggesting that price-per-unit figures are declining and that prices per square foot have dropped 5% year-over-year. Cap rates are up "modestly" in small-cap multifamily, he adds.

Fuchs stresses that these statistics are largely preliminary. A small-balance multifamily - or commercial - meltdown akin to the collapse seen in residential is by no means imminent or even likely. "We are still talking about a very robust market," he points out.

Furthermore, encouraging demographic trends point to a general multifamily market that is currently sound and expected to continue to record strong levels of demand. Baby Boomers' children - known collectively as Echo Boomers - often work in lowpaying jobs and move often, thus usually occupying apartments, Krawitz says. Immigrants and members of minority groups, whose populations are likewise growing, tend to rent as well.

A partial departure from homeownership in the wake of rising foreclosures is also predicted to bolster the apartment market. "It's pretty clear that the residential market is going to get much worse in the months ahead," says Fuchs. "You've got all the resets on variable-rate loans that will be occurring over the next year."

Although an accompanying slowdown in certain economic growth drivers may slightly hurt the commercial real estate markets as a whole, he notes, home buying troubles significantly propel increasing apartment rentals in both the large-balance and small-balance areas.

LNB Commercial Capital's Dave Lilley remarks that rent prices have increased in recent months - a promising sign.

Along with the demographics-fueled rise in demand, falling supply may have contributed to this rent increase. Krawitz does not expect foreclosed homes to be converted to rentals and add to the available pool in any substantial numbers, while a continuing wave of condo conversions has reduced the number of rentals, adds Lilley.

Evaluation

By definition, multifamily transactions and their underwriting have always emphasized cashflow, notes Lilley, whereas high-leverage properties with no similar measure of stability - and no documentation - contributed to problems in residential. As a result, currently, "There's an environment of fear with anything mortgage-related," he acknowledges.

One immediately noticeable result of the risk aversion created by previously lax lending practices in residential, and - to a lesser degree - commercial, has been a recent return to more stringent due diligence and underwriting in small-balance multifamily lending.

Therefore, in light of the market's developments, participants seeking funding in a small-balance transaction should be prepared to prove sufficient cashflow for the property in question, whose viability may be evaluated even more strenuously than in the previous environment.

According to Fuchs, "There is going to be more of a reliance on quantifying the cashflows and debt-service coverage ratios than there may have been before."

More than the borrower's credit qualities or operation history, the property itself will usually come under heavy scrutiny - a departure from other types of deals and one that some participants new to the market may not realize, Lilley adds. His firm will

pursue deals on properties whose owners have no operating record as long as the property history is solid, though a property management firm may become involved in some cases as a safeguard.

In-depth knowledge of the multifamily market is also crucial for landing a successful deal. "If you have a good understanding of the property and it's reflective of the market, then you've got a good chance of placing it," says Lilley.

Once the property in question has been evaluated, Krawitz suggests relying on an experienced broker to ensure success through completion of a deal. The lender-broker relationship, he says, is crucial for the deliverability of a proposal, especially under conditions where capital may be less available than before.

Understanding of a specific market's intricacies, as well as the ability to perform cashflow analysis and other technically demanding tasks required for successful commercial real estate participation, may elude some of the most recent entrants to the business, who include increasing numbers of brokers with residential backgrounds.

Residential brokers who have begun to expand their businesses into commercial multifamily transactions in response to the downturn in their original domain have achieved mixed results - and been met with a mixed response from commercial veterans.

Whether a broker who has traditionally dealt with residential properties is interested in a one-off transaction or is looking to diversify business long-term, LNB Commercial Capital seeks to cater to these participants, particularly "the residential broker who is testing the waters in the commercial area," Lilley says.

Many of these residential refugees, though, "do not have the appropriate skill set and are not going to be able to transition appropriately" into commercial brokerage, warns Krawitz. While some will adapt successfully, the trend is "something small-balance commercial lenders need to be on the lookout for and be cautious about," he says.

The entry of residential brokers into small-balance multifamily may have also triggered a rise in occurrences of residential-style underwriting, says Fuchs. Residential brokers who are "habitually oriented toward low-doc approaches" often continue their practices once they enter the commercial realm, he explains. "So there's been pressure to accommodate those sources of origination."

The capital markets have reacted with opposition to the infiltration of risky loans, demanding the across-the-board return of protective measures and more conservative lending terms. "It does put a little more onus on the residential brokers to understand cashflow and debt-service coverage more than they perhaps did," Fuchs remarks.

Seasoned commercial dealmakers, however, may need to adapt in certain ways as well. "With all the turmoil in the market, you need to dig a little deeper and ask some questions," recommends Krawitz. Many seemingly rate-locked transactions, for example, may lock only base instruments unless specific arrangements have been made.

He considers verifying coverage of a total rate-of-return swap an essential step before signing an agreement. “You need to know that the credit component has been hedged by the lender. That would give you further confidence that the rate you thought you were locking is indeed the rate that you have locked,” he explains, adding that a borrower may need to pay more for a lender who will properly lock a rate in this manner.

Market performance

Despite some possible pre-transaction changes as a result of shifting lending rules, once the deal has been signed, small-balance multifamily loans tend to be a safe bet as part of what Fuchs characterizes as “a very large and robust marketplace.” The overall default rate on commercial loans large and small remains extremely low - particularly in comparison to numbers posted on the residential side.

“Even though people did step out fairly aggressively in deal structures for the past two years in the large-loan space, net operating income should be such that these deals should come through okay,” predicts Krawitz. He expects no major delinquency jump to rattle the commercial world.

Moreover, yield has been largely consistent, he notes. Perhaps most tellingly, anyone seeking funding in this sector can generally do so at nearly the same rate as before the broader markets began to stumble. “Ultimately, you may have had a widening of spreads to reflect a lack of liquidity in the marketplace,” he says, but at the same time, both base Treasuries and swap instruments have dropped.

Fuchs sees “somewhat of a logjam on the conduit side,” although the same drop in liquidity - not any problems with the fundamentals of the market - is likely to blame for this condition as well. Conversely, “Portfolio lenders are in a very good position right now because they can hold the stuff,” he says, and government-sponsored enterprises are also expected to continue to occupy a leading role.

Once erroneously and persistently associated with residential mortgages, small-balance multifamily has separated itself from the larger commercial real estate pack, according to Krawitz. “Small-balance is going to come out on top,” he says. ●